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ESTATE PLANNING AND TICs:

Utilizing TICs in Estate Planning Can Help Ease Tax Woes

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For many investors age 50 and older, the cornerstone of wealth can be found in their real estate holdings. The transfer of this wealth to the next generation, however, can present challenges that may significantly reduce the cash value of the property and in some cases create discord among those inheriting.

Before deciding how to structure the real estate inheritance, investors that own and manage income-generating property should consider the questions their heirs will face.

- Will one or all of the heirs want to assume the significant responsibility of managing tenants and maintenance?

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- Will a sudden partnership with siblings cause friction?
- If one or more heirs wish to sell, will the property be at its peak value?
- How much of the property's appreciation will be lost to capital gains taxes?

Real estate investors who consider these questions and find that traditional inheritance measures may not be the best choice for their families have an option: divesting their portfolio of direct management real estate and reallocating those funds to a fractional ownership via a tenancy-in-common (TIC).

The real estate owner sells sole ownership in a smaller property and exchanges it for fractional ownership of institutional quality real estate that would be out of reach for most individual investors. If the investor structures the sale and subsequent TIC purchase in accordance with Section 1031 of the Internal Revenue Code, capital gains taxes may be deferred on the property sold. The advantages to this tactic are two-fold: the investor is able to relinquish day-to-day management of the property and still receive a monthly income stream while simultaneously creating a more flexible financial legacy to leave heirs.

The flexibility comes into play as heirs may make individual decisions about whether they want to sell their stake and pay the capital gains tax, or keep the investment. This is particularly important when there are two or more heirs. With a TIC, an heir may not need to force a sale to cash out, and the heirs have fewer decisions to make than if they had inherited full or part ownership of property they would have to manage.

When structured properly, TIC investments allow investors to comply with Section 1031of the Internal Revenue Code, which says a property owner can defer capital gains tax on a sale by exchanging property for a "like-kind" replacement property. The owner must identify the replacement property within 45 days of selling of the original property, and must close on the purchase within 180 days of selling the original property. Experts advise anyone interested in a 1031 exchange to research their options well before the sale so they are prepared to meet the requirement of identifying the replacement, which could very well be a TIC property, within 45 days of closing.

1031 exchanges are not restrictive in terms of property type, so that an investor can exchange a small apartment building for partial ownership of an office building, industrial space or even vacant land.

A property owner that wants to complete a 1031 exchange by purchasing a TIC replacement property works with a TIC sponsor, who locates the property, completes the due diligence on the property, obtains the financing, closes the deal, and structures agreements to deal with property management. IRS guidelines issued in 2002 determined the maximum number of tenants-in-common in any offering to be 35.

The power of this strategy is validated in the numbers: exchanges using TIC property as a replacement property under Section 1031 reached an estimated $15 billion in 2006.

Consider this scenario: a parent owns an apartment building valued at $2 million. The investor wants to get out of management responsibility and invest elsewhere, but doesn't want to severely compromise profit by paying capital gains taxes. So, the investor finds a sponsor and purchases a 10 percent TIC interest in a $20 million office building, receiving a deed and a title policy for a fractional ownership. Over

the years, this investor receives its percentage of the rental income from the property, and takes advantage of the depreciation deduction and potential appreciation in value.

In its estate planning, the investor decides to leave its TIC interest to two adult children—a five percent share each. The heirs can choose individually to sell off their TIC ownership interest and pay capital gains tax or to continue receiving income from the TIC property.

When considering a TIC property to complete a 1031 exchange, investors should examine their own financial goals, the types of property available and the amount of acceptable risk. For example, investors that wish to sell property that has increased rapidly in value and want to exchange it for secure cash flow and minimal management will want to select a stable, fully leased investment property.

The track record and investment philosophy of the TIC sponsor should also be weighed heavily. In addition, a potential TIC investor should always look at the real estate experience of the TIC sponsor's senior management team as well as the sponsor's level of financial commitment in the offering.

Many property owners see a TIC investment as an opportunity to shed management responsibilities and own a percentage of higher quality, more substantial real estate than they could ever buy alone. For those considering estate planning, however, this strategy can meet an even higher goal—ensuring that the inheritance left behind provides loved ones with the freedom to make investment decisions that enhance their lives.

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